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FM AMEMBASSY BEIJING
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INFO RUEHKO/AMEMBASSY TOKYO 1586
RUEHCN/AMCONSUL CHENGDU 8665
RUEHGZ/AMCONSUL GUANGZHOU 3462
RUEHGH/AMCONSUL SHANGHAI 8418
RUEHSH/AMCONSUL SHENYANG 8319
RUEHHK/AMCONSUL HONG KONG 9721
RUEHIN/AIT TAIPEI 6666
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E.O. 12958: N/A
TAGS: ECON EIND ENRG ELAB SENV WTRO CH
SUBJECT: CHINA/STEEL: XINJIANG MILL (SORT OF) CHARTS ITS OWN COURSE
AMIDST REFORMS

SUMMARY

¶1. (SBU) Econoff recently held a series of steel related meetings in Xinjiang Province with local government officials and the Xinjiang Bayi Iron and Steel Company (Bayi). A Bayi executive told us that the company has successfully merged with Shanghai's Baosteel. Xinjiang Province Government support was the key to a successful deal. The merger will infuse much needed capital, management expertise, and technology into Bayi while Baosteel gains access to Bayi's rich natural resource holdings. Bayi is expanding its production capacity, reducing its workforce, and eliminating some social services, said the official. Xinjiang Government officials noted that the national-level steel policy has little influence on Bayi and Xinjiang's steel sector. Finally, we note that similar cross-provincial border mergers in China's steel sector will remain elusive until some tax issues can be resolved. End Summary.

BAOSTEEL NOW CONTROLS XINJIANG STEEL MILL

¶2. (SBU) Bayi's Deputy Director of Business Development told Econoff during a meeting at the company that Bayi's merger this year with Chinese steel giant Baosteel has been a big boost to the company. Baosteel acquired a 66 percent stake in Bayi for 3 billion renminbi (RMB). Baosteel acquired Bayi's iron ore, steelmaking, and energy and natural resource companies in the deal. The executive stated that Baosteel's primary motivation for the deal is gaining access to Bayi's natural resource holdings, including coal and metals relating to iron and steel production. Bayi gained access to management expertise, technology, and capital from the merger. The biggest impact of the merger on Bayi so far is coordination of its business plan with Baosteel, said the executive.

PROVINCIAL SUPPORT KEY TO MERGER'S SUCCESS

¶3. (SBU) The Bayi executive said that support of the Xinjiang provincial government, in particular the provincial party secretary has been the key to the successful merger. The provincial government is encouraging local enterprises to cooperate with enterprises from other provinces. Xinjiang officials believe this will open additional markets to local companies and bring in needed managerial talent and technology. The Bayi executive told us that the provincial government retained a 20 percent stake in Bayi. The government also still has the right to select members of Bayi's management team, according to the executive.

BAYI's BUSINESS LOCALLY FOCUSED

¶4. (SBU) The Bayi executive told us that the company is the largest taxpayer in Urumqi. Larger state-owned enterprises (SOEs) have operations in the area, most notably Sinopec, but their tax revenue largely leaves Xinjiang since they are headquartered elsewhere. The executive noted that 60 percent of Bayi's steel production is consumed locally with the remaining 40 percent sold in nearby provinces. The company has its own iron ore mines in Xinjiang mitigating the impact of rising international iron ore prices. International iron ore prices are twice that paid by Bayi for its own iron ore, according to the executive. The executive did note that Bayi imports most of the scrap metal it uses from Kazakhstan.

BAYI PLANS EXPANSION, GREATER EFFICIENCIES

¶5. (SBU) The Bayi executive said that the company's steel production in 2007 will total 4 million metric tons, a 400,000 metric ton increase over 2006. As part of its Eleventh Five Year Plan, Bayi hopes to expand production to 6 million metric tons by 2011. The company also intends to invest in energy conservation and environmental protection equipment and technology. The executive noted that Bayi is closing some of its older, inefficient production capacity, including small blast furnaces, small scale rolling machines, and hot rolling machines. Bayi uses 6.4 metric tons of water per ton of steel it produces, according to the executive. A significant improvement given that only a few years ago the company used 13 metric tons of water per ton of steel produced.

¶6. (SBU) The executive noted that Bayi currently uses 700 kilograms of standard coal equivalent of energy per ton of steel produced. The company's goal is to reduce this to 600 kilograms per ton of production, claimed the executive. The executive stated that Bayi primarily relies on the Xinjiang power grid for its power supply. The company maintains its own separate power generation capability, but it is insufficient to provide full-time power. The executive noted that Bayi is recycling its steel production waste gases to provide some additional power, but does not have plans to expand this beyond its current limited capacity.

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BAYI SLIMING WORKFORCE, LOSING SOCIAL SERVICE ROLE
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¶7. (SBU) The Bayi executive stated that the company is spinning off several subsidiaries over the next few years. Bayi plans to reduce its steel company workforce from 39,000 employees to around 20,000 employees. The company will only retain managers with direct experience in the steel business. The executive noted that Bayi's parent company is also downsizing. The parent company is made up of around 40 subsidiaries divided into four main categories: Bayi, construction and maintenance businesses directly related to Bayi, non-steel sector enterprises, and social service enterprises. The executive stated that a few of these enterprises have already been spun off with ten more likely to follow.

¶8. (SBU) The executive noted that several of the enterprises already

separated from Bayi's parent company were social service providers. These enterprises performed services ranging from running the parent company's school system to managing company housing. The executive stated that the parent company's vast employee housing stock has been privatized. The parent company offered the housing to employees at below-market prices before opening up to the public, but employees are not required to purchase, or live in the housing. The executive also said that the parent company's schools have been turned over to the local government. A notable exception to this ongoing social service reform is the parent company's medical resources. The company hospital and clinics will probably remain under the company's control, said the executive.

NATIONAL STEEL POLICY NOT RELEVANT HERE

¶9. (SBU) A Xinjiang Province Development and Reform Commission official told us that national steel policies are important, but they will have little impact on Bayi Steel. Xinjiang's steel sector is not experiencing overinvestment or overcapacity problems like other areas of China. Xinjiang only has around 1 percent of China's total steel production capacity. The official said Xinjiang is self-sufficient in power production and is not experiencing power shortages like those areas with too much steel production capacity. A Xinjiang Academy of Social Sciences official noted that some 70 percent of Xinjiang's steel production is used for local construction needs. Local authorities want to increase provincial steel production value by having local companies focus more on making specialty steel products, such as natural gas and oil pipelines, said the official.

COMMENT

¶10. (SBU) The official Chinese press has highlighted Bayi's merger with Baosteel as a groundbreaking cross-provincial boundary deal for the steel sector. A similar deal by Baosteel with Inner Mongolia's Baotou Steel, also rich in iron ore and energy resources, is in the works. China's 2005 Steel Policy advocated these types of deals to promote the growth of flagship enterprises such as Baosteel, reduce outdated production capacity, and enable more efficient use of natural resources. This has been slow to happen. Local experts tell us that this is because of provincial capitals' concerns that they will lose tax revenue to other provinces is a major reason why. In Bayi's case, although not stated during our meetings, our experience shows grounds to suspect a compromise has probably been reached: Baosteel gains Bayi's iron ore and energy holdings and in exchange Xinjiang hangs onto its tax revenue. Baosteel's success in acquiring Inner Mongolia's Baotou and other sought after steel enterprises for now probably requires similar tax deals.

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